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September 26, 2002

Ex Parte

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: Application by Verizon for Authorization To Provide In-Region, InterLATA Services in State of Virginia, WC Docket No. 02-214 - **REDACTED**

Dear Ms. Dortch:

This ex parte is in response to the Staff's request that Verizon respond to several arguments that AT&T and WorldCom raised for the first time in their reply comments regarding Verizon's Virginia rates. As we show below, none of these new arguments bear weight.

1. Virginia Switching Rates Fall Within the Ranges the FCC Had Identified as TELRIC-Compliant at That Time.

AT&T and WorldCom have raised several criticisms of Verizon's Virginia switching rates in their Reply Comments, all of which we address below. As we show in responding to each of their attacks, the methodology the SCC used to set Verizon's switching rates complies with TELRIC principles. But even aside from that, the rates set by the SCC should be approved because they fall well within the range of the "proxy" rates established by the Commission as TELRIC-compliant at approximately the same time that the SCC was determining Verizon's UNE rates.

AT&T's threshold argument is that the Virginia switching rates, which the SCC adopted based on the record before it in 1997, are too high and outside the range of TELRIC rates because (according to AT&T) *new, more recent* cost information would produce lower rates *today*. But the Commission has repeatedly rejected the notion that subsequent developments can undermine the legitimacy of rates set during a state's UNE cost proceeding; instead, as the Commission has made clear, the Commission's goal here is to determine whether the rates established by the SCC were a reasonable application of TELRIC *at the time they were set.* *See, e.g., Delaware/New Hampshire Order* ¶ 57 ("[R]ates may well evolve over time to reflect new information on cost study assumptions and changes in technology, engineering practices, or market conditions"); *BellSouth Five State Order* ¶ 100 ("[W]e have consistently recognized that rates may well evolve over time to reflect, among other things, new information and technology"); *Vermont Order* ¶ 37 ("[M]ere evidence that the data underlying a rate is old . . . does not demonstrate that the [state commission] committed any clear error when it adopted the rate."); *Maine Order* ¶ 30 ("The fact that rates may be subject to change based on new information does not, however, require rejection of a section 271 application."); *Rhode Island Order* ¶ 31; *New York Order* ¶ 247; *AT&T Corp. v. FCC,* 220 F.3d at 617 (D.C. Cir. 2000) ("If new information automatically required rejection of section 271 applications, we cannot imagine how such applications could ever be approved in this context of rapid … technological change."). And in this case, there is contemporaneous evidence -- the Commission's default TELRIC proxy rates -- that the rates set by the SCC were within what the Commission *itself* believed to be the range that a proper application of TELRIC principles would produce.

As described in the Woltz/Garzillo/Prosini Declaration submitted with Verizon's Application, the SCC initiated its pricing proceeding in January of 1997, just several months after the Commission established its TELRIC rules. *See Woltz/Garzillo/Prosini Decl.* ¶ 13. In the *Local Competition Order*, released only months earlier, the Commission had set default proxy UNE rates for use by states unable to meet statutory deadlines for conducting full TELRIC proceedings. *See, e.g.*, *Local Competition Order* ¶¶ 787, 790. As the Commission itself made clear, the FCC proxy ranges were "designed to approximate" TELRIC prices. *See id.* ¶ 782. The Commission set a proxy range of $0.002 per minute and $0.004 per minute for the usage-sensitive components of local switching, and a range of $1.10 to $2.00 for the fixed port component.[1/] As noted in paragraph 50 of the *Woltz/Garzillo/Prosini Declaration* submitted with Verizon's Application, the SCC-approved per-MOU switching rate is $0.003104, and the SCC-approved port rate is $1.30. Both of these figures fall well within the ranges set by the FCC, and thus should be deemed presumptively TELRIC-compliant.

This is especially the case given that the SCC was presented with the task of setting TELRIC UNE rates less than a year after the passage of the Act, at a time when there was a vastly more limited body of case law, state decisions, and FCC explication of TELRIC principles. Thus, the fact that the Virginia SCC adopted switching rates very similar to, and possibly guided by, the rates that the FCC itself adopted as complying with TELRIC, should be *per se* evidence that, at the time the SCC was adopting those rates, it was complying with all TELRIC principles as those principles had been interpreted and applied at that time. And, as

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[1] *See* Order on Reconsideration, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Dkt. No. 96-98, 11 FCC Rcd 13042, ¶¶ 5, 8 (1996) ("Reconsideration Order").

noted above, with respect to whether the SCC's decision should be approved in the context of a section 271 application, *that* is the critical issue.

This Commission concluded, based on the evidence available between 1996 and 1998, that switching rates falling within a certain range complied with TELRIC. Since the SCC's assessment of the record evidence available to *it* at roughly the same time produced a rate well within the range that the FCC had promulgated as TELRIC-compliant, no further analysis should be necessary for the Commission to acknowledge that, at the time the SCC made its determination, it complied with TELRIC.

2. Verizon's Analysis of Feature Costs Complies With TELRIC

To the extent the Commission nonetheless concludes that it must consider each of the CLEC's arguments concerning the methodology underlying the SCC-approved switching rates, we respond to each of those in turn. We respond first to WorldCom's claim that Verizon's switching rates reflect "excessive" feature costs. *See WorldCom Reply Comments* at 5. The Commission briefly addressed similar "complex issues regarding feature cost modeling" in its recent *BellSouth Five State Order*, but concluded that it had no need to resolve them "because BellSouth's non-loop rates in [the applicant states]… pass[ed] a benchmark comparison to BellSouth's non-loop rates in Louisiana." *Id.* ¶ 97. As we show here, WorldCom's contention rests on various misleading and erroneous arguments.

First, WorldCom suggests that the feature costs should be lower than they are (and lower relative to overall usage costs of the switch) because the "*software costs* associated with features are generally far lower than the usage costs that encompass the switch hardware for all basic switching functions." *See Frentrup Decl.* ¶ 6 (emphasis added). But this makes no sense.

Verizon's feature costs are *not* software-related but instead consist exclusively of the processor and hardware costs necessary for the switch to provide features. Verizon recovers ongoing software expenses related to the provision of features through the so-called "Right to Use" factor included in its overall annual cost factors (ACFs).

WorldCom also complains that Verizon's feature costs make up too large a *percentage* of the switching rate, and are too high vis-à-vis the costs associated with usage. *Frentrup Decl.*¶ 6. But this comparison is meaningless. The percentage of switching costs allocated to the feature costs category versus the usage category is merely a function of cost allocation. In the Virginia cost study, which applied a "bottoms up" approach to assessing costs, the costs of each individual feature were studied and allocated to the feature costs category. In particular, Verizon estimated the amount of processor capacity (and hardware) that would be needed to provision each feature, and allocated those costs to the features category, rather than the general usage category. In more recent cost studies that Verizon has performed, including the New York cost study, Verizon used a "tops down" approach, in which the processor costs of features were looked at as a whole and allocated en masse to the "usage" category; only the service-specific hardware costs associated with certain features were included in the "features" cost category (through the application of line port additive UNE rates). Thus, while the ratio of feature costs to usage costs may differ significantly between the Virginia and New York cost studies, for example, this does not mean that the *amount* of feature-related costs differs. Accordingly, pointing to the percentage of feature versus usage costs is simply pointing out a function of cost allocation in Virginia -- a decision on which the FCC typically defers to the states, *see, e.g.*, *Maine 271 Order* ¶ 28 (mere fact that AT&T could establish a different switching cost allocation

"does not warrant a finding of any clear error by the" state commission) -- that says nothing about the level or propriety of the underlying costs themselves.

Nor is there any basis for the suggestion that Verizon's actual feature *costs* are problematic. WorldCom alleges that Verizon's feature costs are inflated by the assumption "that all 26 available features are used on all lines." *See Frentrup Decl.* ¶ 7. But WorldCom misapprehends the methodology Verizon used to calculate its feature costs in the SCC proceeding. As Verizon previously has explained, *see Verizon September 20, 2002 Ex Parte*, Verizon assumed that under a forward-looking, TELRIC network construct, the switching UNE would have to include the capability for each CLEC to provide each of its customers with access to all 26 basic switching features. As the Commission made clear in the *Local Competition Order*, ILECs are required to provide the switching UNE so that "when a requesting carrier purchases the unbundled local switching element, it obtains *all* switching features in a single element on a per-line basis." *Local Competition Order* ¶ 412; *see also* Reconsideration Order ¶ 11 ("[A] carrier that purchases the unbundled local switching element to serve an end user effectively obtains the exclusive right to provide *all* features, functions, and capabilities of the switch." (emphasis added)). Indeed, before the Supreme Court, the Commission specifically defended its decision to require that ILECs provide CLECs with access to features because they "are entitled to make use of those functions (just like other functions) of the element they have paid for."[2/] Accordingly, the cost of the switching UNE must be based on the cost of a switch that necessarily would have to include the appropriate amount of switching processor capacity to provide each potential CLEC customer with those features.

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[2] Reply Br. for the Federal Petitioners and Br. for the Federal Cross-Respondents, *FCC v. Iowa Utilities Board*, Nos. 97-826 *et al.* at 48 (June 1998).

This assumption is not based on the erroneous premise that every customer necessarily *will* use all 26 features, as WorldCom suggests. *See Frentrup Decl.* ¶ 2. But since Verizon cannot predict which or how many of the 26 features any CLEC customer will order -- yet nonetheless remains *obligated* to be *able* to serve CLECs if their customers order features -- Verizon must ensure that at any given time there is sufficient capacity in the switch processor for the CLEC to be able to provide *any* or *all* such features to its customers. While Verizon theoretically could base processor capacity on some estimate of Verizon's customers' feature usage, Verizon has no way to know whether CLECs' customers will use features in the same manner; indeed, there is reason to expect that this will *not* be the case, since -- as they can do in the context of resale -- CLECs may market and price their services very differently from Verizon's, by, for example, offering flat-rated feature usage. And as the FCC has recognized, section 251(c)(3) requires that ILECs provide access to all features "whether or not the incumbents also offers those services to its customers,"[3/] and has noted that "the carrier that purchases the local switching element is likely to provide *all available services* requested by the customer served by that switching element."[4/] The only means of providing CLECs with the unfettered ability to offer features to their customers as part of the switching UNE is to ensure that there is sufficient processor capacity; underbuilding processor capacity based on underestimates of feature orders could result in the need to expand or replace processor capacity on very short notice and at high cost in order to serve the higher-than-expected demand.

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3 Id.

4 *Reconsideration Order* ¶ 11 (emphasis added).

Verizon modeled feature costs by determining, for each feature, how much processor capacity was required each time the particular feature is used, and multiplying that cost by the average frequency with which customers typically use such features. The costs for each feature also reflect any additional resource needed to provide that specific feature, such as specific hardware, memory or additional line usage. The resulting total costs were converted to an MOU basis and included in the MOU originating and terminating rates for switching. As the Virginia SCC found, this approach to calculating feature costs is a "proper application of the Act's definition of [the switching] network element."[5/]

Finally, WorldCom asserts that feature costs "are not appropriately included in traffic sensitive charges at all." *Frentrup Decl.* ¶ 4. But processor costs are properly assigned to the usage-sensitive MOU rate. Switch resources shared among users (which processor costs are) are sized before deployment based on expected *usage levels*; the magnitude of those resources (*i.e.*, the amount of processor capacity) and thus their costs increase with the level of expected usage.[6/] They are thus inherently usage-sensitive and are appropriately recovered on a usage-sensitive basis.

3. Verizon Appropriately Allocates Usage-Sensitive and Non-Usage Sensitive Costs.

AT&T's more general argument that Verizon has misallocated switching costs between usage and non-usage sensitive rates fails for similar reasons. AT&T alleges that the "getting started" costs of the switch should be treated as fixed and allocated to the port rate, not the

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5 VA SCC's Final Order Determining UNE Rates (Final Order) at 17 (Apr. 15, 1999).

6 In the Virginia UNE arbitration before the FCC, in fact, Verizon demonstrated that it has had to upgrade and expand processor resources as a result of exhaustion due to usage that exceeded the forecasted demand. Verizon Virginia Inc., Recurring Cost Panel Surrebuttal Testimony, CC Dkt. No 00-251, at 175-78 (Sept. 21, 2001).

usage-sensitive rate, because, AT&T claims, these "'getting started'" switch costs do not vary with respect to the number of lines and trunks on the switch or switch usage.'" *Baranowski Decl.* ¶ 9. But as noted above, these shared switch resources (processor, memory, and other "common equipment," *id.*) *do* vary with usage. And the mere fact that they are sized ahead of time does not change that fact; the sizing of these resources is based on *anticipated* usage, and if the estimate proves too low, the resources will have to be supplemented. Indeed, as the Commission recently recognized in the *Delaware/New Hampshire Order*, ¶ 60, "recovery of the 'getting started' costs via a minute-of-use ('MOU') charge is consistent with TELRIC and the Commission's rules."

In any event, as noted previously, the FCC typically defers to the states on questions of cost allocation. *See, e.g.*, *Delaware/New Hampshire Order* ¶ 61 (states retain the flexibility to adopt reasonable allocation ratios); *Maine Order* ¶ 28. And even if that were not the case, the Commission has approved a traffic-sensitive/non-traffic sensitive cost allocation that allocated even *more* costs to the traffic-sensitive category. In the *Maine Order*, this Commission deferred to the state commission decision under which traffic sensitive costs accounted for 70% of total switching investment, while non-traffic-sensitive costs accounted for the remaining 30% of investment. *See id.* ¶¶ 26-30. The current Virginia rates presume an almost identical proportion, with a slightly *higher* non-traffic-sensitive component. Specifically, the Virginia rates presume that 66% of investment is traffic-sensitive, and 34% is non-traffic sensitive. *See, e.g.*, App. G, Tab 4. This is almost identical to the cost allocation scheme the Commission approved in the recent *BellSouth Five State Order*, in which the Commission found that the Alabama's "allocation of 32% fixed/68percent minutes-of-use" complied with TELRIC. Thus, the

relationship inherent in the costs approved by the SCC is well within the range that Commission has found TELRIC-compliant for section 271 purposes.

4. The SCC's Switch Discount Was Appropriate Given the Circumstances and Is Within the Reasonable Range TELRIC Permits.

The CLECs have challenged the switch discount selected by the SCC -- 54% new and 46% growth additions -- on the ground that it is not TELRIC-compliant. *See Baranowski Decl.* ¶¶ 12-13; *WorldCom Reply Comments* at 5. AT&T argues, in addition, that the SCC failed to explain how it arrived at that discount after first having determined that a discount of 85% new and 15% growth addition was appropriate. *See AT&T Reply Comments* at 6. But the SCC made a reasonable choice based on the record before it. As the D.C. Circuit has recognized, TELRIC must take into account the fact that the evidence available to state commissions is not always perfect and that the state commission must at times make the most reasonable decision that the circumstances and the record permits: thus, for example, the court rejected claims that the Commission had acted arbitrarily or capriciously in approving non-recurring Kansas UNE rates, even where the state commission had simply "split the baby, adopting a weighted average of the AT&T (2/3) and SBC (1/3) proposals," recognizing that the state had made a reasonable determination based on the record before it.[7/]

In this matter, there were only a few switch discount proposals pending before the SCC: Verizon's proposal of 37% new and 63% growth, Staff's proposal of 85% new and 15% growth, the CLECs' 100% new proposal, and the proposal that was produced on cross of Staff's witness -- 54% new and 46% growth. Although Verizon believed and continues to believe that its own

7/ *Sprint Communications Company v. FCC*, 274 F.3d 549, 558 (D.C. Cir. 2001).

switch discount was the most appropriate, the SCC did not agree. It also sensibly rejected an all-new switch discount. And while it originally embraced the 85/15 proposal that Staff supported, ultimately the Commission recognized that, given its other assumptions about depreciation lives and other inputs, the 54/46 discount mix was a more appropriate long run approach. *See, e.g.,* July 8, 1998 letter from Hugh Stallard, Verizon, to SCC at 6 (explaining merits of 54/46 discount),(App. F, Vol. 10, Tab 31). Indeed, the Virginia Cable Television Association (VCTA) submitted comments arguing that the appropriate switch discount mix was approximately 50/50, and that accordingly the most reasonable proposal on the record was the 54/46 that had emerged from Verizon's cross-examination of Staff. *See Comments of Virginia Cable Telecommunications Association on Staff Report,* October 6, 1998 at 7, *Comments of Virginia Cable Telecommunications Association*, July 31, 1998 (attached as Attachment 1), *see also* June 29, 1997 Hearing Transcript at Tr. 2708 (App. F, Vol. 8, Tab 22) citing Hearing Exhibits PPH-P192, PPH-P192A (attached as Attachment 2).

Staff's 85/15 discount mix proposal apparently was based on the assumption of a five year planning period and approximately 3% annual line growth over 5 years. By this, Staff apparently meant that an ILEC would purchase a new switch with enough capacity to serve the expected demand for the first five years, and then have to supplement the switch with growth additions for line growth in years 6-10 -- although at some points in the record, it is not entirely clear that Staff did not in fact assume that the entire planning period, in which any growth additions presumably would have to take place, was five years. *See* May 21, 1997 SCC Staff Report, Case No. PUC970005 at 85 .(App. F, Vol. 1, Tab 9); *but see* August 31, 1998 SCC Staff Report on Bell Atlantic-VA's Refiled Cost Studies, Case No. PUC970005 at 23-24 (App. F, Vol.

10, Tab 33). However, Staff nowhere on the record justified why either ten *or* five years was the appropriate period to consider. And Staff witness Mr. Hlavac conceded, during cross examination, that if a longer period were studied -- the full 18-year life assumed for the switch -- the percentage of growth additions would necessarily increase. *See* June 29, 1997 Hearing Transcript at Tr. 2708 (App. F, Vol. 8, Tab 22).

Although the SCC initially did accept Staff's proposal, Verizon submitted comments arguing that if the Commission were going to use something akin to Staff's approach to calculate the discount, it should use the 18 (actually 17.5) depreciation life it had set, not the arbitrary ten year period proposed by Staff. *See Verizon's Comments on Staff Report,* October 6, 1998 at 21 (App.F, Vol.10, Tab 37). As Verizon explained, the SCC "cannot, in the case of depreciation, assume long lives for switches, and in the case of switch replacements, assume much shorter lives." *Stallard Letter* at 7 (App. F, Vol. 10, Tab 31). The SCC accepted this argument and adopted the 54/46 proposal.

That proposal was eminently reasonable. As the attached spreadsheet illustrates (attachment 3), that switch mix can be calculated by assuming an 18 year depreciation life, 3% annual growth rate, the 10.12% cost of capital set by the SCC (for use in calculating net present value), and that growth additions cost 3 times more than new switches due to the difference in discounts. The latter assumption accords with the discount data that Verizon provided to the parties before the SCC; for example, for Lucent POTS switches, the new switch discount was 79.4%, while the growth discount was 22.5%, resulting in a ratio of 3.53. *See Bell Atlantic-Virginia Interrogatory Response No. 97* (Attachment 4). As the spreadsheet further illustrates, Verizon assumed that the new switch would have only enough extra capacity to serve the first

year of growth, so that growth additions would be required beginning at the end of year one. This assumption accords with reasonable and efficient network planning, as it balances the additional costs of supplementing the switch with the costs of surplus capacity and the associated depreciation and related costs.

5. AT&T's Suggestion that Verizon Should Have Assumed the Use of GR303 Is an Attempt To Revise History

AT&T suggests that Verizon's study before the SCC improperly assumes 100% TR008 and fails to assume any GR303. *See Baranowski at 9.* But AT&T's challenge here is one it did not raise below. Indeed, *no* party to the SCC proceeding (including AT&T) suggested the use of *any* GR303, for the simple reason that the technology was not yet "currently available" and in fact was not even known when the cost studies and testimony were presented. But as the Commission has noted repeatedly, "it is … generally impractical for [the Commission] to make determinations about issues that were not specifically raised before the state commission[] in the first instance." *BellSouth Five State Order* ¶ 31. *See also id.* ¶ 97 ("[T]he Commission does not have the time or the resources during our 90-day statutory review period for section 271 applications to resolve complex technical disputes about cost model assumptions."). This is sufficient reason to dismiss AT&T's challenge. *Id.* ¶ 32. ("In such cases, we will not find that the objecting party persuasively rebuts the *prima facie* showing of TELRIC compliance if the BOC provides a reasonable explanation concerning the issue raised by the objecting party.")

Notably, the testimony Mr. Baranowski cites in support of the use of GR303 is from a BellSouth proceeding that took place in *2001 -- four years* after the testimony before the SCC was presented; thus, even Mr. Baranowski does not pretend that there was evidence relating to GR303 in the case before the SCC. While the concept of "next generation digital loop carrier"

was known (and referred to as NGDLC), and while Verizon in fact included a hypothetical cost in its study to reflect the assumed savings that would be presumably associated with next generation DLC systems (based on an average of the cost of UDLC and IDLC at that time), GR303 in particular was not proposed or discussed. It accordingly was not assumed in SCIS/MO. It makes no sense whatsoever to fault studies that, when performed, complied with TELRIC's mandate to use "currently available technology" simply because in the interim between the study and the 271 review, a new generation of technology has been developed -- even if, unlike GR303, that technology is suitable for use in Verizon's network. If that were the approach, there could be no certainty that any state UNE decision was, and would later be found to be, consistent with the law. AT&T's argument essentially seeks to fault the Virginia studies because they are based on data that allegedly has been overtaken by subsequent developments, and as mentioned above, the Commission has repeatedly made clear that section 271 applications should not be denied on that basis. *See, e.g.*, *Delaware/New Hampshire Order* ¶ *57; BellSouth Five State Order* ¶ 100; *Vermont Order* ¶ 37; *Maine Order* ¶ 30; *AT&T Corp.*, 220 F.3d at 617.

6. The Analysis AT&T Submitted from Mr. Baranowski Is Flawed

AT&T next argues that Verizon's switching rates must be overstated because Verizon's switching usage rates would allegedly recover more than Verizon's initial switching usage investment. *See Baranowski Decl.* at 3-4. As we show below, the analysis on which AT&T relies for this point -- essentially the same analysis and the same point AT&T raised in the Delaware 271 proceeding -- is riddled with errors. Verizon notes that it has *not* attempted to recalculate Mr. Baranowski's analysis after correcting for the myriad flaws set forth below. This is because, even aside from the many flaws we have identified in the Baranowski approach,

Verizon does not agree with the underlying premise of his analysis: that Verizon's switching rates would remain the same over the assumed 17-year life of the switch. To the contrary: given the TELRIC regulatory construct, Verizon's UNE rates are repeatedly reset, and in the majority of cases *reduced*, every few years. Indeed, the Supreme Court specifically recognized that under TELRIC prices are repeatedly adjusted to reflect changes in technology and other developments. *Verizon Comm. v FCC*, 122 S. Ct. 1646, 1670 (2002). And if any question remained, the pending Virginia arbitration proceeding before the FCC should eliminate it: in that proceeding, the CLECs have, not surprisingly, proposed lower switching rates than the current rates. Given the virtual certainty that Verizon will never be permitted to recover the amounts that Mr. Baranowski assumes by forecasting usage over 17 years since the rates are revisited and revised as often as every three or four years, there is little point in trying to correct the other flaws in his analysis to come up with the figure that would result, in some hypothetical world outside the realm of TELRIC, if Verizon were permitted to collect the rates that the SCC set for 17 years. That analysis would be an exercise in pure speculation, as there is no way to know what the future rates for switching will be over the life of the switch.

As Verizon previously demonstrated in the context of its Delaware 271 proceeding, ,(*see Martin/Garzillo/Sanford Reply Declaration* at 10-14), and reiterates again here, AT&T's analysis is fatally flawed.

To begin with, the "total" switching investment identified by AT&T witness Mr. Baranowski, and used to "prove" the alleged over-recovery, is in fact a derived figure that grossly understates Verizon's total switching investment. The ****** that Mr. Baranowski alleges is Verizon's total switching investment (from which he derives ****** in investment

relating to switching usage), *see Baranowski Decl.*¶ 5, is from the SCIS cost model, and represents only the total "*material* " costs for actual switching equipment as reflected by the price charged by the vendor. But the *total* switching investment (and thus the total switching usage-related investment) also must reflect the additional costs that Verizon incurs to place a switch into service, including costs for engineering, furnishing and installing the switching equipment ("EF&I costs"), the power costs Verizon incurs to operate central office switching equipment, and the costs Verizon incurs for land and building investments required to house this equipment. Mr. Baranowski's alleged "total" switch investment excludes *all* of these costs.

Nor does Mr. Baranowski's alleged total investment figure include the costs Verizon incurs to replace switch equipment that malfunctions or is damaged or the equipment investment necessary to provide vertical features. And while AT&T suggests the latter "has no material affect on [its] analysis," *Baranowski Decl.* ¶5 n.1, to the contrary, vertical feature special hardware accounts for approximately an additional ****** percent of the total material switch investment generated by the SCIS model.

AT&T also fails to exclude from the Virginia switching usage rate certain amounts that are designed to recover *expenses,* and *not* investment costs. Certain expenses associated with Verizon's UNE billing systems, with equipment and facilities required to connect host and remote switches, and other implementation expenses were not included in Verizon's annual cost factors. Because these expenses are recovered through Verizon's MOU switching rate, it makes no sense to compare the usage rate to usage *investment* without first backing out these expenses from the rate. But Mr. Baranowski does not make this adjustment, and thus distorts the ratio of investment "recovery" to actual investment.

In addition, AT&T improperly assumes that the number of minutes of use generated by Verizon's TELRIC study will remain constant over the 17-year life of the switch that AT&T assumes for its analysis. *Baranowski Decl.* ¶ 5, n. 3. AT&T even suggests that the annual minutes of use will *grow* over time. *Id.* In the current competitive telecommunications marketplace, in which CLECs are increasingly deploying their own switching equipment, the assertion that usage will remain constant or grow over the next 17 years is questionable at best. The use of wireless, cable modems, and dedicated data services such as DSL have all contributed to recent declines in usage of Verizon's switching network. And the development of other new technologies and services such as IP telephony likely will further cut into circuit switched minutes of use in the years to come. AT&T's analysis is therefore founded on an inherently flawed assumption.

7. Mr. Baranowski's Other Criticisms Similarly Lack Weight.

Mr. Baranowski next implies that Verizon's Virginia switching rates may be inflated *if* Verizon did not consistently apply three sets of inputs related to processor utilization, busy hour traffic, and individual feature costs in the SCIS/MO model. *Baranowski Decl.* ¶¶ 6-8. But while Mr. Baranowski goes on for several paragraphs about how switching rates could be incorrect "*if* these inputs are not consistent," *id.* ¶ 6 (emphasis added), he never even attempts to show that Verizon *did* use incorrect or inconsistent assumptions. And to the contrary, the inputs Verizon used were reasonable and informed by the opinions and data provided by experienced switch engineering experts and product managers. For example, inputs regarding the average originating and terminating minutes of use in a busy hour were provided on a per line basis by central office design engineers who monitor switch usage. In sum, AT&T's unsupported

speculations fail to demonstrate that Verizon has misapplied any inputs and falls far short of evidencing a TELRIC violation.

This ex parte contains proprietary information and has been redacted. A confidential version is also being filed. Please let me know if you have any questions. The twenty-page limit does not apply as set forth in DA 02-1857.

Sincerely,

Attachments

cc: U. Onyeije
B. Olson
G. Remondino
T. Preiss
V. Schlesinger

ATTACHMENT 1

REDACTED – FOR PUBLIC INSPECTION

Lydia
file

CHRISTIAN & BARTON
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October 6, 1998

Mr. William J. Bridge, Clerk
State Corporation Commission
Document Control Center - 1st Floor
1300 East Main Street
Richmond, VA 23219

Dear Mr. Bridge:

Re: Ex Parte: To determine prices Bell Atlantic-Virginia, Inc. is authorized to charge Competitive Local Exchange Carriers in accordance with the Telecommunications Act of 1996 and applicable State law - Case No. PUC970005

Enclosed for filing are an original and fifteen (15) copies of the *Comments of the Virginia Cable Telecommunications Association On Staff Report* (the *VCTA Comments*).

I enclose an additional copy of the ***VCTA Comments***. Please have it file stamped and returned to our messenger. Thank you.

Sincerely,

John D. Sharer

John D. Sharer

Enclosures
cc: Service List
#446251.1

RECEIVED

OCT 14 RECD

Vice President,
General Counsel & Secretary

A. SWITCH-EQUIPMENT MIX

The VCTA's position regarding specification of the appropriate switch-equipment mix (*i.e.* 54% replacement and 46% add on) is set forth on pp. 15-17 of the VCTA's July 31, 1998, comments ("VCTA July Comments"). In contrast with the Staff Report, the VCTA's position, in essence, is that the use of an 85% replacement rate and a 15% add-on rate for the calculation of switch price discounts does not properly represent forward-looking costs given the configuration constraints of Bell Atlantic-Virginia's current local network.

By accepting the locations, sizes, and other aspects of Bell Atlantic-Virginia's ***present*** network (*e.g.*, wire centers), the optimal network design for forward-looking technology has been effectively waived. Rather, the optimal number, mix, and location of switches pertinent to TELRIC studies flow directly from the configuration of Bell Atlantic-Virginia's present local network, and not from a contemporary architectural plan developed to optimize the forward looking capabilities of network topology and equipment. The VCTA submits that the same constraint (*i.e.*, replacement and add-on characteristics of an ***existing*** network) should be recognized in selecting an appropriate switch price discount.

At any point in time during the building and operation of a large existing local network, switches are being replaced as they reach the end of their respective service lives. Other switches are being modified through add-on equipment and facilities. Some entirely new switches are also being installed as new central offices are created. Depending on the period examined, different replacement and add-on rates will be observed, *e.g.* 85% replacement/15% add-on as proposed in the Staff Report, or 37% replacement and 63% add-on as proposed by Bell Atlantic-Virginia. However, as such a

network reaches a steady-state equilibrium, the most probable and frequently observed outcome would approach 50% replacement and 50% add on.

Thus, newly installed switches will have a base (or skeleton), which is sized to accommodate growth for a long period of time, typically the expected service life of the switch. These new switches will be equipped initially with circuit specific and volume sensitive common equipment (the so-called "wired" condition) to accommodate growth for a shorter period of time, perhaps three to five years. During the time period the switch is initially "wired," both the replacement and add-on percentages are zero. Subsequent to this initial "wired" period, and throughout the service life (or base period), the switch will accommodate growth through additions (add-ons).

If the new forward-looking switch network were ubiquitous over an area of operations, and if each switch base installation were sized to accommodate the service life, as described above, there would be no replacement until all of the switches simultaneously reached the end of their service lives. That is, the "replacement" percentage would be zero and the requirements to meet the growth in switching capacity would be met with "add-ons."

In an existing network, at any point in time, switches are being replaced (at the end of their respective service lives) and other switches are being increased in capacity (through add-ons). The percentages of switches that are represented by replacements and add-ons vary throughout any selected study period. Therefore, to assume that 100% of the growth beyond the initially "wired" capacity would be met through additions, and that none would be met through replacements does not represent forward-looking costs. Instead, representative "replacement" and "add-on" percentages should be selected or determined.

In the requirements for Bell Atlantic-Virginia's Compliance Filing, and as noted above, the Staff selected an 85% replacement and a 15% add-on switch-equipment mix. In contrast, Bell Atlantic-Virginia proposed a 37% replacement and 63% add-on mix. VCTA's position is that 85% replacement is too high and 37% replacement is too low. A figure in the mid-50% range is appropriate. As noted above, if the switch replacements are uniformly distributed over the study period, and the demand growth is uniformly distributed over the network, the average replacement rate would be about 50%. Due to the initial "wired" states of each switch (on average) the network-wide replacement rate would be zero during the "wired" period, while the replacement rate over the remaining service lives of the switches (on average) would be greater than 50%.

These considerations underlie VCTA's recommendation to use a 54% "replacement" and 46% "add-on" mix to determine the switching equipment discount levels.

B. INTERIM NUMBER PORTABILITY

The Staff (pp. 31-32) endorses the method of recovering interim number portability ("INP") costs "from all carriers based on each local exchange carrier's relative number of active telephone numbers." This is one of the four alternative mechanisms outlined by the FCC in CC Docket No. 95-116 to be "competitively neutral" in recovering the costs of number portability as required by § 251(e)(2) of the Telecommunications Act of 1996 ("Act"). The Staff Report, however, makes no distinction between the alternative INP cost recovery methods deemed by the FCC as fulfilling the requirements of the Act and the INP cost recovery methods that might be appropriate for Virginia given the Act's mandate and the history of actual TELRIC proceedings.

In contrast, the VCTA drew this distinction in its July Comments. Specifically, the VCTA recommended (p. 19) that the "Commission should order the costs of Interim Number Portability

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July 31, 1998

Mr. William J. Bridge, Clerk
State Corporation Commission
Document Control Center - 1st Floor
1300 East Main Street
Richmond, VA 23219

Dear Mr. Bridge:

Re: *Ex Parte: To determine prices Bell Atlantic-Virginia, Inc. is authorized to charge Competitive Local Exchange Carriers in accordance with the Telecommunications Act of 1996 and applicable State law - Case No. PUC970005*

Enclosed for filing are an original and fifteen (15) copies of the *Comments of the Virginia Cable Telecommunications Association Concerning Compliance Filing of Bell Atlantic-Virginia, Inc. and Appropriate Cost Recovery Mechanism for Recovery of Interim Number Portability Costs* (the *VCTA Comments*).

We are filing separate proprietary and non-proprietary versions of the *VCTA Comments*. We are submitting an original and fifteen copies of the proprietary version in a sealed envelope. Simultaneously, we are filing an original and fifteen copies of the non-proprietary version. We are providing courtesy copies of the proprietary version to the Commission Staff. We are serving the non-proprietary version on the rest of the service list.

I have enclosed additional copies of the proprietary and non-proprietary versions of the *VCTA Comments*. Please have both copies file stamped and returned to our messenger. Thank you very much.

Sincerely,

John D. Sharer

John D. Sharer

Enclosures
cc: Service List
#446251.1

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Vice President,
General Counsel & Secretary

CAPCOST PLUS run be set equal to the service life of investment. This is precisely what CAPCOST PLUS (except for buildings and conduit) automatically does in any event under the 40 year planning period assumption.

The VCTA does not recommend, however, that such a modification be made because its end-result would likely be inconsequential. ***First***, buildings and/or conduit constitute only a relatively small portion of the incremental investment needed by BA-VA for UNE provisioning and delivery. ***Second***, the present values of long-run incremental costs associated with buildings between years 40 and 60, and with conduit between years 40 and 50 in the future, not presently captured in the CAPCOST PLUS runs underlying BA-VA's Compliance Filings, are also comparatively small, if not *de minimis*. Furthermore, the VCTA believes that the generosity that the Commission has extended to BA-VA in other areas far more than compensates for the comparatively minor oversight with respect to buildings and conduit.[4]

G. Switch Replacement and Growth

The net costs that BA-VA incurs for switching investment depend upon the volume and nature of purchases of new switching plant on a competitive basis from vendors (lower average per unit line costs), as well as its decision to expand existing switching plant through non-competitive purchases from existing vendors (higher average per unit line costs). In the *May 22 Order* (p. 11), the Commission directed that the net cost applicable to switching investment for TELRIC purposes be

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4/ To illustrate, based on studies of the Aberdeen Road Wire Center in BA-VA's July 8, 1998 Compliance Filing, the VCTA estimates that the recurring cost of **[Start of Proprietary] SXXX** for the loop would rise to **SXXX [End of Proprietary]** upon making the building and conduit adjustments noted.

determined in accordance with an 85% replacement (new switch purchases) of investment and 15% growth (additions to existing switches).

Mr. Stallard asserts that the effect of such a high switch replacement rate is to accentuate the lower average per line cost which reduces the overall switching cost. He claims the "effect of such a high switch replacement rate is to produce an unrealistically low switching cost"; that this "switch replacement rate is flatly contradicted by the Commission's depreciation assumptions which dictate that switches will have lives of 17.5 years"; and that the "Commission, to be consistent, cannot have it both ways...in the case of depreciation assume long lives for switches, and in the case of switch replacements, assume much shorter lives." (Stallard Letter, p. 7) Accordingly, Mr. Stallard proceeds to urge the Commission to modify its replacement/growth finding to either 54%/46% or 37%/63%.

Once again, Mr. Stallard is mistaken. There is no inconsistency between the use of an 85% replacement/15% growth premise for determining the net cost applicable to incremental switch investment ***today***, and the service life period over which such a switch should be reasonably depreciated ***in the future***. These are truly two entirely separate issues. BA-VA's costing models (which the Commission has accepted) determine the net cost of switches using assumptions as to the replacement/growth composition of switch investment; *e.g.*, a lower net cost flows from 85%/15% than from 54%/46%. The fact that BA-VA has chosen to relate them in some fashion does not mean that the Commission's decision is wrong.

This fact is also clearly evident in existing competitive markets where the depreciation practices of firms that buy plant and equipment need not relate in any material way to the prices charged by firms that sell plant and equipment. Although general economic trends will have similar influences, depreciation practices in one industry nonetheless will be affected by a set of competitive forces that

largely differ from those that affect the prices charged in another industry. Only under conditions where firms have substantial monopoly power in output markets, and monopsony power in input markets, could one reasonably expect the same set of forces and equivalent outcomes to prevail. Mr. Stallard's attempt to equate switch investment service lives, net costs, and the replacement/growth assumptions rests on a view of the world that arguably might be appropriate under traditional rate of return regulation, but that clearly is incompatible with the major goals of the 1996 Act.

The VCTA has undertaken a technical and economic review of the "replacement"/"growth" issue and believes that the effective result of one of the Staff's switch replacement studies, which is 54% replacement and 46% growth, strikes a reasonable balance between Mr. Stallard's 37% replacement and 63% growth and the 85%/15% required for the Compliance Filing. Accordingly, the VCTA recommends that the Commission adopt the 54%/46% ratio of replacement and growth to determine the permanent prices in this proceeding.

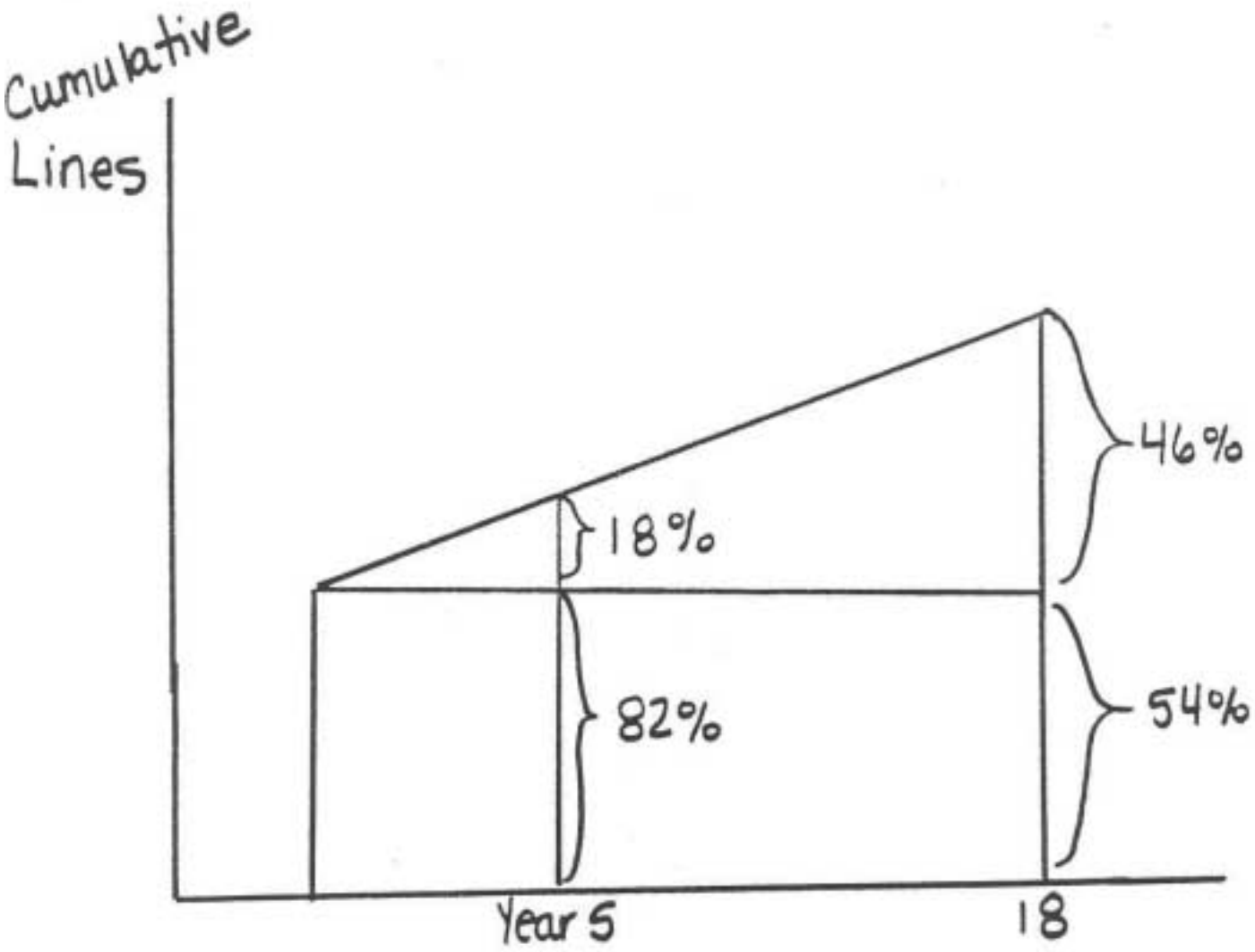
H. Revised Exhibit RWW-193

Mr. Stallard does not explain – and thus, one can only ponder – how the so-called "updated" Exhibit RWW-193 attached to Mr. Stallard's letter was developed. Furthermore, "updated" Exhibit RWW-193 is rife with unreasonable premises. The implicit assumption that the $1.547 billion in annual revenue cited therein properly represents what BA-VA should be currently allowed to collect for its services is most notable in this regard. To illustrate, suppose an appropriate annual revenue level for BA-VA is currently $1.0 billion. This would mean that with a 13% resale discount, resale revenue would be $870 million rather than the $1.345 billion listed in Revised Exhibit RWW-193. Further, the $1.390 billion cited therein for BA-VA's proposed UNE prices not only become even more excessive, but also would suggest that BA-VA is grossly inefficient.

ATTACHMENT 2

REDACTED – FOR PUBLIC INSPECTION

SWITCH MIX

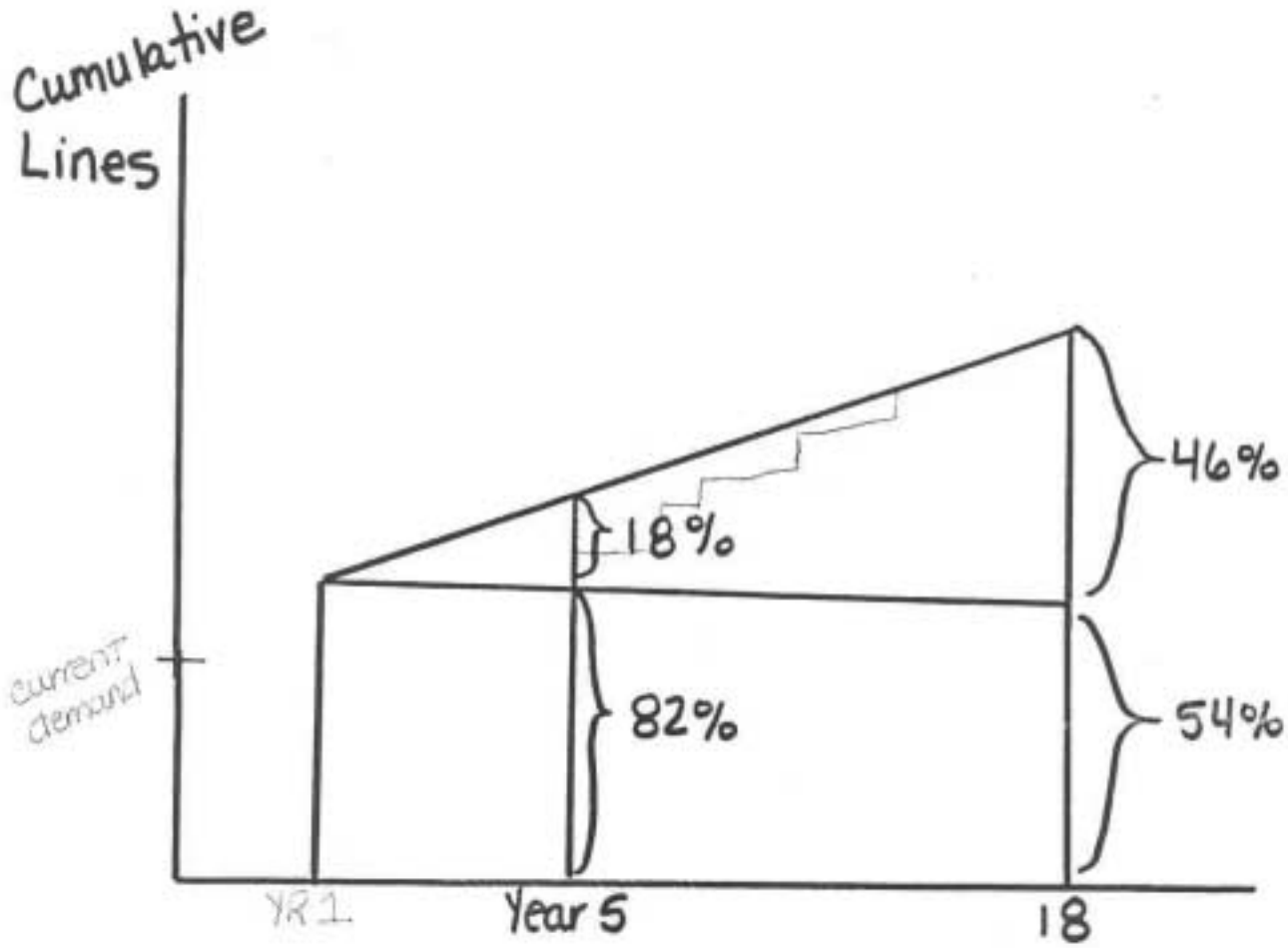


18-add-on-63

82- new - 37

PPH-P192A

SWITCH MIX



18-add-on-63

82- new - 37

ATTACHMENT 3

REDACTED – FOR PUBLIC INSPECTION

ATTACHMENT 4

REDACTED – FOR PUBLIC INSPECTION